IN THE

Supreme Court of the United States

October Term, 1945

No. 384

FORREST S. SMITH, Trustee of the Property of Hoboken Manufacturers Railroad Company, Debtor, SEATRAIN LINES, INC., and HOBOKEN MANUFACTURERS RAILROAD COMPANY,

Petitioners,

vs.

HOBOKEN RAILROAD WAREHOUSE AND STEAMSHIP CONNECTING COMPANY, and HOBOKEN LAND AND IMPROVEMENT COMPANY;

Respondents.

BRIEF FOR RESPONDENTS.

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

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BRIEF FOR RESPONDENTS.

Reference to the Opinions Delivered in the Courts Below.

The opinion of the District Court of the United States for the District of New Jersey, rendered on August 4, 1944, is reported in 56 F. Supp. 187; also reproduced in this record (R. 42).

The opinion of the Circuit Court of Appeals for the Third Circuit, rendered on July 17, 1945, is reported in 150 Fed. (2d) 921; also reproduced in this record (R. 94).

Statement of the Case.

Petitioners' statement of the case is such that it requires amplification.

The Hoboken Land and Improvement Company, one of the respondents, owns a majority of the capital stock of the Hoboken Railroad Warehouse and Steamship Connecting Company, the other respondent, which is herein referred to as the lessor, the owner-lessor, and the Connecting Company. The Connecting Company is the owner of the railroad property which is the subject of this controversy. The property is located on the Hudson River water-front in New Jersey, more than 95% thereof being in the City of Hoboken in that State. Neither of the respondents owns any of the securities of the Hoboken Manufacturers Railroad Company, the debtor and the lessee of the railroad property, and they have no pecuniary interest in that company. They are creditors in the reorganization proceeding.

On June 19, 1906, the Connecting Company leased to the debtor a line of railroad, including all rights of way, roadbed, tracks, rails, ties, freight-houses, terminals, yards, engine-houses, car and machine shops, rolling stock and other equipment, in the City of Hoboken, New Jersey, for a period of ninety-nine years. The lease contained a provision (Article Third (1)), against the sale, assignment or transfer thereof, or the underletting of the demised premises or any part thereof, without the previous consent of the lessor endorsed upon the lease. It provided that the covenant against such sale, assignment or transfer should apply to any unauthorized sale or transfer, whether made by the lessee "or in any proceeding, whether at law or in equity or otherwise, to which the Lessee may be a party, whereby any of the rights, duties and obligations of the Lessee shall or may be transferred, encumbered, abro-

gated or in any manner altered, without the consent of the Lessor first had and obtained in the manner hereinbefore provided" (R. 64-65). The Fifth Article of the lease provided that upon the failure to observe, keep and perform the covenants and agreements thereof, after such default had continued for a space of thirty days after notice from the lessor thereof, the lessor might at its option by notice in writing terminate the lease and thereupon enter into and upon the demised premises and that the right, title and interest of the lessee should thereupon absolutely cease and terminate as though the lease had never been made (R. 71).

The rental reserved by the lease was the sum of several items as follows (R. 11-12):

(1) A stated amount of $22,000.00 per year (later reduced to $21,500.00 per year)

(2) An amount per ton of freight transported over a certain amount, as specified in the lease, and referred to as "excess tonnage"

(3) All premiums of insurance upon the leased premises

(4) All taxes upon the demised premises or upon the lessor by reason of its ownership thereof and of the appurtenant franchises, or upon the rent reserved by the lease and which the lessee may be required to pay thereon or retain or deduct therefrom under any present or future law.

Petitioners are in error in referring to this lease and agreement as being a lease only of the "main-stem" or part of the railroad. Upon reference to Article Third of the lease, it will appear very clearly that this indenture conveyed an entire fully equipped switching railroad, having an established or going business or freight traffic, to the

lessee, and contemplated that the same fully equipped and going plant with the additions and betterments made during the term of the lease should revert to the lessor upon expiration or earlier termination of the lease (R. 63-68).

The owner-lessor constructed and equipped this railroad and later initiated its operation on September 7, 1897 (R. 50). It operated the railroad from September 7, 1897 to June 19, 1906, the date of the lease (R. 50-51), thereby creating a going business. It obtained the operating rights for the railroad—a charter from the State of New Jersey on September 17, 1895, and a franchise from the City of Hoboken on October 23, 1895 (R. 50). By the lease it delegated these operating rights to the lessee. So the question here is whether an entire equipped and going switching railroad, including its operating rights, shall or shall not revert to its owner for operation by the owner.

Up to the time of filing the petition for reorganization herein, the debtor had paid the lessor the base rental of $21,500.00 fixed by the lease and had reimbursed it for insurance premiums. It refused to pay Federal income and excess profits taxes levied against the lessor, and certain excess tonnage, claiming that such taxes and tonnage did not come within the terms of the lease (R. 11-14). The lessor thereupon demanded arbitration under a clause of the lease providing therefor, and the arbitrators made an award against the lessee in the total amount claimed by the lessor, namely $24,102.43 (for the fiscal years beginning July 1, 1932 and ending June 30, 1939). The lessor thereafter commenced an action at law in the Hudson County Court of Common Pleas to recover the amount of the arbitrators' award, and the debtor filed a bill in the New Jersey Court of Chancery to restrain the prosecution of the action. The Chancery suit was determined adversely to the lessee, which thereupon appealed to the Court of

Errors and Appeals. That court affirmed the Court of Chancery and on or about July 2, 1943, lessor entered judgment in its action at law in the Hudson County Court of Common Pleas against the lessee in the amount of $27,965.00. In the meantime, and on or about March 31, 1943, the lessor instituted a second action at law in the Hudson County Court of Common Pleas for additional rental for the fiscal years ending June 30, 1940, 1941 and 1942 in the amount of $14,566.44 (R. 13).

On July 26, 1943, a little more than three weeks after the entry of the aforesaid judgment, the lessee filed its petition for reorganization in the United States District Court for the District of New Jersey, alleging among other things that the financial condition of the debtor was seriously aggravated by the entry of the lessor's judgment for rent and the pending suit for additional rent (R. 10-16). The petition also alleged that the lessee had no means of borrowing or otherwise procuring funds to meet its obligations, that its cash reserves were wholly insufficient for its financial requirements including necessary working capital, and that therefore it was without funds to continue to operate the railroad and property and maintain the same in condition and repair to render adequate service to the public and at the same time meet its debts (R. 15). The court made an order approving the petition on the day it was filed. Thereafter, Forrest S. Smith was appointed trustee and after the approval of his appointment by the Interstate Commerce Commission, he duly qualified and entered upon the performance of his duties as such trustee on November 12, 1943. On February 14, 1944, the lessor moved for an order modifying the restraints imposed by Order No. 1 (approving the petition for reorganization) so as to permit it to terminate the lease for breach of covenant (R. 30). After oral argument on the motion, the court ordered briefs, and on August 4,

1944, handed down its opinion authorizing such termination (R. 42-45). In the interim and on June 12, 1944, the court entered Order No. 27 (R. 38) on the petition of the trustee (R. 36), authorizing the trustee to adopt the lease and other executory contracts, and pursuant thereto the trustee served notice upon the lessor that he had elected to adopt said lease (R. 39).

In granting the motion to terminate the lease the court ruled that the right to terminate should become effective upon production to the court of conclusive evidence that the requirements of the laws relating to the continuous operation of the railroad had been complied with (R. 45). The lessor thereupon filed a petition with the Interstate Commerce Commission, setting forth the circumstances of the case, and praying for a determination by the Commission that the lessor did not require a certificate of convenience and necessity to resume operation of the railroad. The trustee, the debtor, and Seatrain Lines Inc. (the owner of all of the capital stock of the debtor) sought and obtained permission to intervene in said proceedings and filed briefs opposing the contention of the lessor. On December 2, 1944, the Interstate Commerce Commission filed its report, in which it found that the lessor did not require a certificate of convenience and necessity, and that it had not only the right but the duty to resume the operation of the railroad without such certificate (R. 50-58). Thereafter, and on December 19, 1944, Order No. 39 (R. 58-62), was entered in the District Court, authorizing the lessor to terminate the lease and enter into possession as of midnight, December 31, 1944, and on July 17, 1945 this order was affirmed by the Circuit Court of Appeals for the Third Circuit.

The debtor, asserts that it has title to property of considerable value which will not revert to the lessor under the

terms of the lease. This is denied by the lessor. The District Court, in its Order 39, provided for the adjudication of this dispute through reference to a Master or otherwise (R. 59).

Summary of Argument.

The qualification of the trustee and his subsequent adoption of the lease consummated a breach of the covenant against transfer and assignment, and entitled the landlord to terminate the lease and agreement and repossess its property.

That part of Article Third (1) of the lease which expressly forbids the unauthorized transfer of the demised premises from the lessee in any proceeding in law or equity or otherwise, to which the lessee may be a party, is an enforceable express covenant, as distinguished from the customary general covenant, which prohibits transfer of the demised premises from the lessee to the trustee.

Although a general covenant or condition in a lease against voluntary assignments may not preclude transfer of the demised premises from a lessee to a trustee in a reorganization proceeding the lessor and lessee may, and in the case at bar they did, draft a strong special covenant that will effectually bar such transfer. *Gazlay* v. *Williams*, 210 U. S. 41; *In re Wil-low Cafeterias*, (C. C. A. 2d Cir.) 95 Fed. (2d) 306; *Model Dairy Co.* v. *Foltis-Fischer Inc.*, (C. C. A. 2nd Cir.) 67 Fed. (2d) 704; *Jandrew* v. *Bouche*, (C. C. A. 5th Cir.) 29 Fed. (2d) 346; *In re Georgalas Bros.*, 245 Fed. 129; *Empress Theatre Co.* v. *Hortons*, (C. C. A. 8th Cir.) 266 Fed. 657.

The Chandler Act (Act of June 22, 1938, C 575, Section 1, 52 Stat. 879, U. S. C. Title 11, Section 110, paragraph b) provided in substance that a general covenant against assignment in a lease shall not bar transfers to trus-

tees, but that an express covenant in a lease against assignments by operation of law or the bankruptcy of a specified party shall be enforceable, and Congress has made the provisions of this section applicable to proceedings under Section 77.

The covenant against transfer contained in the lease here before the court is enforceable. It is not against public policy and does not contravene the purposes of Section 77 of the Bankruptcy Act. This is a lease of an entire railroad and an entire railroad will revert to the lessor, which is ready, able and willing to assume the full operation thereof without any interruption whatever. Nor is there any reason to postpone the lessor's right of re-entry until the formulation of a plan of reorganization. Such an application is addressed to the sound discretion of the court under its general equity powers, and has been rejected by both the District Court and the Circuit Court of Appeals in this case. The concurrent findings of the two courts should be accepted as conclusive by this court.

No question of public interest is involved in this case and no discontinuance or interruption of the operation of the railroad has been threatened or contemplated. The Interstate Commerce Commission has ruled that upon re-entry, the lessor will be under a duty to operate the railroad, and that no certificate of public convenience and necessity is required under Section 1 (18) of the Interstate Commerce Act.

This court should sustain the decision of the Circuit Court of Appeals, Third Circuit, and the decision of the District Court, District of New Jersey.

ARGUMENT.

POINT I.

The qualification of the trustee and his subsequent adoption of the lease breached the covenant against assignment and entitled the landlord to terminate the lease.

A. Provisions of the lease.

Article Third, paragraph (l), of the lease provides:

> "The Lessee shall not and will not sell, assign or transfer this lease or underlet the demised premises, or any part thereof, or the rights and privileges, or any of them, hereby granted, without the previous consent of the Lessor expressed by endorsement on this lease made in pursuance of authority granted by resolution of the board of directors of the Lessor, * * *. This covenant shall also apply to any unauthorized sale or transfer thereof or underletting of the demised premises, or any part thereof, or of the said rights and privileges, or any of them, whether made by the Lessee or in any proceeding; whether at law or in equity or otherwise, to which the Lessee may be a party, whereby any of the rights, duties and obligations of the Lessee shall or may be transferred, encumbered, abrogated or in any manner altered, without the consent of the Lessor first had and obtained in the manner hereinbefore provided" (R. 64).

It will be seen that the lessor, by the broadest possible language, sought by this covenant to prevent any transfer of the lessee's rights or obligations under the lease without the consent of the lessor expressed by endorsement on the lease pursuant to a resolution of its board of directors. The covenant prohibited not only a voluntary transfer of the

lessee's interests, but also any transfer made in any proceeding, whether at law or in equity or otherwise, to which the lessee was a party, whereby any of the rights, duties and obligations of the lessee should or might be transferred, encumbered, abrogated or in any manner altered. This contract was voluntarily assumed by both parties. The lease is a carefully drawn instrument covering thirty-two printed pages exclusive of the schedules. At the time of its execution, the lessor had acquired railroad operating rights, a charter from the State of New Jersey, and a franchise from the City of Hoboken enabling it to operate the railroad. It had constructed the railroad and had operated it for nine years, thereby establishing a going business. By this instrument it leased a fully equipped and going railroad to a lessee of its choice in the full knowledge that it as the owner was obligated to resume and perform the operation of the road at any time that its lessee defaulted or became unable to operate. Recognizing the possibility of the sudden reversion of the railroad to it at any time, the lessor in Article Third (b) of the lease (R. 63) required the lessee to efficiently maintain and operate the railroad and to enlarge and improve it in consonance with the growth of the district which it served and the increased traffic available to it. The lessee was required under the lease to keep the railway system of the lessor equipped with a sufficient number of engines, electric motors and cars, and with all the electrical and other power appliances that might be needed, "so that in case of the termination of this indenture at any time, the demised premises shall be adequately furnished and equipped to carry on business and continue its operations" (R. 64).

The lessor, like any other landlord, had a property owner's right to select the tenant who would occupy and use, and who would be charged with the obligation of preserv-

ing, protecting and improving the leased property. It likewise had the right to insist that no other party should succeed to the lessee's rights and obligations without the lessor's consent. This right was far more important to it than it would be to the lessor of an ordinary piece of real estate. It was leasing a going railroad—a costly one-use property which might easily become a money losing proposition, with the consequent degeneration of its plant and equipment, if it were not well managed and if its freight traffic were not stimulated and elevated to a high level. It was charged with the public duty of operating the road in the event of the default or inability of the lessee to continue operation. It was of the utmost importance, therefore, that it should contract only with a lessee of its choice, and that the obligations assumed by the lessee should not be transferred to a third party without the lessor's consent. The lessor guarded against such transfer by the sweeping language employed in the covenant hereinabove set forth, and the lessee freely and willingly executed the lease with that covenant contained therein.

Appellants argue that an ordinary covenant against assignment is not breached by the bankruptcy of the lessee and the consequent transfer of his interest to a trustee. We are in accord with that proposition. In *re Prudential Lithograph Company*, 265 Fed. 869; (D. C. S. D. N. Y.); In *re Levinson*, 295 Fed. 146 (D. C. W. D. Wash. N. D.). It is equally well established, however, that a clause specifically giving the lessor the right to terminate the lease upon the filing of a petition in bankruptcy by or against the lessee is enforceable. In *re Wil-low Cafeterias*, 95 F. (2d) 306 (C. C. A. 2nd Circuit).

In *Model Dairy Co.* v. *Foltis-Fischer Inc.* (C. C. A., 2nd Cir.) 67 F. (2d) 704, the court upheld a clause in the lease permitting the lessor to reenter on the tenant's insolvency, bankruptcy or receivership, saying at page 706:

"It is true that courts do not look upon such conditions with a friendly eye, classing them as forfeitures. * * * Nevertheless they are valid, and we must give effect to the fair meaning of the language used. * * * The receiver, though not truly a tenant, is in possession and prevents him" (the lessor) "from disposing of the premises as he would. Unless the lease contains a condition against passage of title, he must suffer the term to be sold to one whom he may not desire."

In *Jandrew* v. *Bouche*, 29 F. (2d) 346 (C. C. A., 5th Cir.), the lease contained a stipulation against its assignment without the consent of the lessor, and, among other things, that the lessee "shall not permit or suffer any of the goods, * * * or other personal property which may be on the said premises at any time during the period of said lease to be seized under any legal process or to pass into the hands of any receiver or trustee in bankruptcy or other officer, and that this lease shall be personal to the lessees and shall not inure to the benefit of any receiver or trustee in bankruptcy as an asset of the said lessees." The court held that the last quoted clause was one of conditional limitation *ipso facto* terminating the lease without action by either party upon adjudication in bankruptcy and the appointment of the trustee.

In *In re Georgalas Bros.*, 245 Fed. 129 (D. C., N. D. Ohio), the trustee in bankruptcy claimed the right to sell a lease which the lessor claimed was void. The lease contained a provision that "if the lessee shall be adjudged bankrupt; or shall make an assignment for the benefit of his creditors, or if this lease shall pass by transfer, operation of law, or otherwise from said lessee to any other party without the written consent of the lessor", the lessor may void the lease and reenter. The question before the court was whether the lease had passed "by operation of law or otherwise from said lessee to any other person without the

written consent of the lessor." The court concluded that the lessor had the right to avoid the lease, saying, page 131:

> "It is not asserted that the lessor had consented, in writing or otherwise, to the transfer of this lease by operation of law to the trustee. The only right of the trustee to sell the lease is by virtue of the transfer thereof by operation of law to him. It is inconsistent to assert title in the trustee by operation of law, and yet to say that the title still remains in Theodore, and that the covenant is not broken. An adjudication in bankruptcy against a partnership, it is settled law in this circuit, operates to transfer by law to the trustee all the property and assets of the individual members of the partnership. * * * It is by virtue of this legal effect of an adjudication of the partnership to be bankrupt that the trustee acquires a right or title to this lease. It is equally effective to operate as a transfer by operation of law of the lease, so as to bring about a violation of this covenant.
>
> "It is also settled law that a lease may be so framed that a transfer by operation of law will avoid the same at the option of the lessor. *Gazlay* v. *Williams*, 210 U. S. 41; *In re Frazin*, 183 Fed. 28. The covenants above quoted, when properly interpreted and understood, bring the facts within its terms, and the lessor's right to avoid the same is well established, and is sustained by the authorities above cited."

In *Empress Theatre Co.* v. *Horton*, 266 Fed. 657 (C. C. A., 8th Cir.), the court upheld a clause in a lease that "no right, title or interest upon this lease shall pass to any trustee in bankruptcy, or by judicial process, or by operation of law, without the consent" of the lessor, and that "the bankruptcy or insolvency" of the lessee shall at the option of the lessor work an immediate forfeiture of the lease. The court said, page 661:

> "* * * The basement leased was a valuable property. The purpose the lessor had in making the

lease, to secure the operation in this basement of a high class cafe with special amusement features, made the solvency of the lessee and hence its continuous operation of the cafe essential to the accomplishment of this purpose. Its insolvency or bankruptcy, placing the basement in the hands of a trustee for a long time during bankruptcy proceedings, and then sending it to an unknown purchaser, would undoubtedly to a large extent defeat the object of the lessor in making the lease, produce the vacancy or inadequate operation of the proposed cafe, and result in immeasurable damage to the leased premises and to the value of their use. It was to prevent this contemplated possibility that these parties wrote into their lease the condition and covenant that in case of the insolvency or bankruptcy of the lessee, at the election of the lessor, the term of the lease should end and the leased premises should be returned to the lessor free from the lease."

Petitioners contend, however, that the covenant herein is not a covenant against bankruptcy, nor a covenant providing for termination if the lessee should file a petition in reorganization, and that since the covenant should be construed strictly against the lessor, there has been no breach which would entitle the lessor to terminate the lease.

In *Gazlay* v. *Williams*, 210 U. S. 41, the Supreme Court held that a general clause against assignment prohibits only a voluntary assignment on the part of the lessee, and is not violated by a transfer by operation of law. The court recognized, however, that a covenant against assignment by operation of law was valid and enforceable, and quoted with approval Jones on Landlord and Tenant, as follows (p. 47):

"• • • Jones, in his work on Landlord and Tenant, lays it down (Section 466) that 'An ordinary covenant against subletting and assignment is not broken

by a transfer of the leased premises by operation of law, but the covenant may be so drawn as to expressly prohibit such a transfer, and in that case the lease would be forfeited by an assignment by operation of law'."

Sec. 70(b) of the Bankruptcy Act as amended, 11 U. S. C. A. Sec 110(b), which this court in *Finn* v. *Meighan*, 65 S. Ct. 1147, held was merely declaratory of the law as it then existed provides:

> "* * * A general covenant or condition in a lease that it shall not be assigned shall not be construed to prevent the trustee from assuming the same at his election and subsequently assigning the same; but an express covenant that *an assignment by operation of law* or the bankruptcy of a specified party thereto or of either party shall terminate the lease or give the other party an election to terminate the same, shall be enforceable * * *." (Italics added.)

The covenant in the lease before the court is far broader than a covenant against bankruptcy. It gives to the lessor the option to terminate the lease upon an unauthorized sale or transfer, either by the voluntary act of the lessee or in any kind of legal proceeding to which the lessee is a party, whereby any of the rights, duties and obligations of the lessee shall or may be transferred, encumbered, abrogated or in any manner altered. The purpose of the clause cannot be open to doubt. It was the intention of the lessor to protect itself by the broadest possible language against the voluntary or involuntary transfer of the lessee's obligations under the lease to any other party, without the consent of the lessor. The word "unauthorized", as the context makes clear, relates to the lessor, and the clause operates to vest in the lessor an option to terminate the lease when the transfer of the lessee's interest is accom-

plished in any legal proceeding whatever, which was instituted without the previous consent of the lessor. The clause is in effect a prohibition against the transfer of the lessee's interest in the lease, either voluntarily or *by operation of law.*

B. Transfer of lessee's interest to trustee.

An examination of the language of Sec. 77 makes it clear that a transfer of the lessee's interest by operation of law is precisely what has happened in this proceeding. By Order No. 5 herein appointing Forrest S. Smith trustee it was provided (Par. 6):

> "That following said ratification" (by the Interstate Commerce Commission) "and upon filing such bond, all of the property, real, personal and mixed of every kind and nature whatsoever of the debtor shall by this order be vested in the said Forrest S. Smith as trustee of the debtor's property." (R. 28.)

This order was made pursuant to Sec. 77, (U. S. C. A. Title 11, Section 205, paragraph (c), subdivision (2)), which provides:

> "* * * The trustee or trustees so appointed, upon filing such bond, shall have *all the title* and shall exercise, subject to the control of the judge and consistently with the provisions of this section, all of the powers *of a trustee appointed pursuant to Section 72* or any other section of this title, and, to the extent not inconsistent with this section, if authorized by the judge, the powers of a receiver in an equity proceeding, and, subject to the control of the judge and the jurisdiction of the Commission as provided by Chapter 1 of Title 49 as on August 27, 1935, or thereafter amended, the power to operate the business of the debtor." (Italics added.)

Section 72 referred to in the above quotation is the section providing for the election of a trustee under the Bankruptcy Act. Consequently, by the very words of the statute the title which the trustee herein acquired by virtue of his trusteeship, is exactly the kind of title which a trustee in an ordinary bankruptcy acquires.

It is well settled that upon adjudication in bankruptcy, all the property of the bankrupt vests in the trustee as of the date of the filing of the petition. Sec. 70 of the Bankruptcy Act, U. S. C. A. Title 11, Sec. 110(a); *Isaacs, Trustee* v. *Hobbs Tie & Timber Co.*, 282 U. S. 734; *Gross* v. *Irving Trust Company*, 289 U. S. 342; *Irving Trust Company* v. *Perry*, 293 U. S. 307; *Taylor* v. *Sternberg*, 293 U. S. 470; *Armour & Company* v. *Callahan*, 25 F. (2d) 584 (C. C. A. 4th Cir.); *In re Levinson*, 295 Fed. 146 (D. C. Wash.).

Paragraph (l) of Section 77 of the Bankruptcy Act, U. S. C. A. Title 11, Sec. 205, par. (l), provides:

> "In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the *rights* and liabilities of creditors, and of *all persons with respect to the debtor and its property*, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed." (Italics added.)

It is not open to doubt that if the lessee were an ordinary mercantile corporation the covenant *sub judice* would have been breached if a voluntary petition for adjudication had been filed, and a decree of adjudication had been entered. By the very words of the statute the rights of all persons, including of course the lessor, with respect to the debtor and its property are exactly the same as if a voluntary petition for adjudication had been filed and decree of adjudication entered in an ordinary bankruptcy proceeding.

It is urged by the petitioners that since the purpose of the reorganization under Section 77 differs from that of an ordinary bankruptcy, a covenant against transfer of title by operation of law should not be deemed breached upon the filing of a petition under Section 77. A similar contention, with regard to reorganization proceedings under Chapter X, was rejected by this court in the case of *Finn, Trustee* v. *Meighan*, 65 S. Ct. 1147. In that case, the court held that Congress had made the provisions of Section 70 providing for the enforcement of an express covenant against assignment by operation of law or the bankruptcy of a specified party applicable to reorganization proceedings under Chapter X. With equal clarity, Congress had made the provisions of Section 70 applicable to reorganization proceedings under Section 77. As was pointed out above, Section 77 in terms provides that a trustee appointed thereunder shall have all of the title * * * of a trustee appointed under Section 72 or any other section of the title. Section 72 is the section providing for the election of a trustee in ordinary bankruptcy proceedings, and Section 70 deals with the title which such trustee acquires. It is perfectly obvious, therefore, that the provisions of Section 70 are applicable to reorganization proceedings under Section 77, just as they are applicable to reorganization proceedings under Chapter X, and that upon the basis of the decision of this court in *Finn* v. *Meighan, supra*, a covenant against assignment by operation of law is breached by proceedings under Section 77.

It seems clear, therefore, that under the statute and the decision of this court the title to the lessee's interest in the lease became vested in the trustee, if not upon his qualification, certainly upon his adoption of the lease. *Palmer* v. *Palmer*, 104 F. (2d) 161 (C. C. A. 2nd Cir.). We therefore have an unauthorized transfer of the demised premises and of the rights and privileges of the lessee made in a pro-

ceeding "whether at law or in equity or otherwise" to which the lessee was a party, and by virtue of which the rights, duties and obligations of the lessee were transferred, abrogated and altered.

It is evident that the rights, duties and obligations of the lessee were transferred, abrogated and altered by the vesting of the title in the trustee. The lessee's obligation to pay the rental was transferred to the trustee. The duty imposed upon the lessee of operating the railroad was transferred to the trustee. Its obligation to maintain and improve the railroad and to keep it properly equipped, so that it could handle the expanded traffic in harmony with the growth of the community it served, passed from the lessee to the trustee. The duty imposed upon the lessee to stimulate the traffic of the railroad and to protect the lessor's operating rights likewise passed to the trustee. In fact, all of the rights the lessee acquired and all of the duties and obligations it assumed by virtue of the lease, passed from the lessee to the trustee, without the consent of the lessor. Thus the very situation which the lessor was careful to guard against by the inclusion of the covenant in the lease, was consummated.

To summarize, there has been an unauthorized transfer of the lessee's interest in the lease in a legal proceeding to which it was a party, by virtue of which the rights, duties and obligations of the lessee passed to the trustee. The District Judge held that that transfer took place upon the qualification of the trustee (R. 41). Ever if this court should disagree with the court below on that point, it cannot be gainsaid that such a transfer verainly took place upon the trustee's adoption of the lease (*Palmer* v. *Palmer*, *supra*). The transfer took place without the consent of the lessor. We submit, therefore, that the covenant contained in Article Third (l) has been breached, and that the lessor is entitled to terminate the lease in accordance with the terms thereof.

POINT II.

The covenant against transfer is enforceable; it is not contrary to the Bankruptcy Act or to public policy.

Petitioners contend that the purpose of Section 77 is different from that of an ordinary bankruptcy; that no distribution of the assets of the debtor is contemplated, but only a holding off of the debtor's creditors until such time as a reorganization can be accomplished. They further contend that the difference between the two procedures grows from the interest which the public has in the continued operation of a railroad, and quote Mr. Justice SUTHERLAND in *Continental Illinois National Bank and Trust Company* v. *Chicago Rock Island Pacific Ruy. Co.*, 294 U. S. 648, at 671 that:

> "A railway is a unit; it cannot be divided up and disposed of piecemeal like a stock of goods. It must be sold, if sold at all, as a unit and as a going concern. Its activities cannot be halted because its continuous, uninterrupted operation is necessary in the public interest; and, for the preservation of that interest, as well as for the protection of the various private interests involved, reorganization was evidently regarded as the most feasible solution whenever the corporation had become 'insolvent or unable to meet its debts as they mature.'"

Petitioners seek to draw from the admitted difference between a railroad reorganization proceeding and an ordinary bankruptcy proceeding the conclusion that the enforcement of a covenant against transfer, such as is contained in the lease here in question, would defeat the purpose of Section 77 and be against public policy. It is submitted that no such conclusion is warranted. A reorganization proceeding under Chapter X likewise differs from an ordinary proceeding in bankruptcy. The primary purpose of a Chapter X reorganization is not the distribu-

tion of the debtor's assets among its creditors, but a holding off of the creditors until a plan of reorganization can be effectuated. With regard to the protection of the private interests involved, the primary purpose of a Chapter X reorganization proceeding is identical with a proceeding for the reorganization of a railroad under Section 77. It is only where the primary purpose of Chapter X cannot be accomplished that the proceeding may be turned into an ordinary bankruptcy and the debtor's assets distributed among its creditors.

As has been pointed out above, this court has held that a covenant against assignment by operation of law or the bankruptcy of a specified party is enforceable in a Chapter X proceeding, just as it is in an ordinary bankruptcy. *Finn, Trustee* v. *Meighan, supra.*

The only essential difference between a reorganization under Chapter X and a railroad reorganization under Section 77 is that the public has an interest in the continued operation of the railroad. That interest is not in jeopardy in this case. The District Court was careful to see that the continued operation of the railroad was assured. It refused to enter the order terminating the lease until proceedings were had before the Interstate Commerce Commission, establishing the lessor's right to take up the operation of the road. In those proceedings, the Commission held that the lessor not only had the right but the obligation to do so, and that no certificate of public convenience and necessity was required from the Commission because the lessor's obligations and duties to the public had never ceased, but had merely been performed by the lessee for its (the lessor's) benefit during the term of the lease (R. 56-57). The landlord has always recognized and now recognizes its obligation to step in and operate the railroad.

Petitioners argue that *Continental Bank* v. *Chicago Rock Island, etc. Rwy.*, 294 U. S. 648, supports in principle

their contention that covenants such as that contained in the lease before the court cannot be enforced in a proceeding under Section 77. Not only does that case not support such a contention, but, we respectfully submit, it leads to the inevitable conclusion that such covenants are perfectly valid, but that in a proper case a court may, under its general equity powers, temporarily enjoin their enforcement.

In the *Rock Island* case, a petition was filed for the reorganization of the Chicago Rock Island and Pacific Railway Co. The railroad system involved comprised over eight thousand miles of line, running through many states of the Union. It operated numerous subsidiary companies, had a complicated capital structure and there was outstanding a great volume of securities held by many and widely separated creditors with varying rights. It had outstanding collateral notes, secured by mortgage bonds, part of which were issued by it and part by corporations forming a part of the system. Upon default on the notes, the holders were entitled to sell the security pledged therefor. The debtor filed a petition setting forth its default on the interest due on some of the mortgage bonds and the imminent default on others, and prayed that the court determine whether in the event of default it should enjoin the holders of the collateral notes from selling any of the collateral. The District Court found that it was necessary for the enforcement of Section 77 that the holders of the notes be enjoined and restrained from selling or disposing of the collateral pending the preparation and consummation of a plan of reorganization, because an immediate sale thereof would seriously embarrass and probably prevent the formulation of any plan. The Circuit Court of Appeals affirmed the order. This court held that the concurrent findings of the two courts should be accepted as conclusive, unless clearly erroneous. This court was careful to point out, moreover, that

the injunction in no way impaired the lien or disturbed the preferred rank of the pledgees (as indeed it could not under Section 67 (d), but did no more than suspend the enforcement of the lien by a sale of the collateral, pending further action.

The *Rock Island* case, therefore, cannot be cited as authority for the proposition that a covenant against transfer is unenforceable in a reorganization proceeding under Section 77. At most, it stands for the proposition that in a proper case and upon a showing that the immediate enforcement of the right would endanger the continued operation of the railroad, a court in the exercise of its proper equity power might suspend temporarily the enforcement of the right of re-entry.

The distinction between the facts in the *Rock Island* case and those in the case at bar is obvious. The lease herein involved is for an entire switching railroad, comprising approximately nine miles of main stem track. It would not be dismembered by the re-entry of the lessor, which would take up the operation of the railroad immediately. The debtor has no complicated financial structure. It has no outstanding bonds or secured indebtedness. All of its capital stock is owned by Seatrain Lines Inc. (R. 11). The filing of the petition followed closely upon the entry of judgment against the debtor for unpaid rent under the lease and the institution of a suit for additional rent thereunder. It is evident both from the petition itself (R. 10) and from a petition of the trustee filed on January 20, 1944 (R. 72) that the principal, if not the only reason for the filing of the petition was the inability of the debtor to pay the rent under the lease. It is apparent, therefore, that the only plan of reorganization which could be submitted by the debtor would involve a new lease on different terms.

To that the lessor will never agree, and the injunctive power of the court should not be exercised for the purpose of awaiting the futile gesture of a plan of reorganization which can never be consummated.

An application to withhold from the landlord its right of re-entry pending a plan of reorganization was made in this case and properly refused. The conclusion of the District Court was approved by the Circuit Court of Appeals, which said:

> "Under the circumstances, it can scarcely be held that the court below has abused its discretion in permitting a reentry by the landlord." (R. 97).

It is fundamental that a trial court's exercise of a discretionary power will not be disturbed unless it has been improvidently exercised; and that where, as here, the District Court's action has been approved by the Circuit Court of Appeals, the concurrent findings of the two courts should be accepted by this court as conclusive unless clearly erroneous. *Continental Bank* v. *Chicago, Rock Island & Pacific Railway Co., supra; United States* v. *Commercial Credit Co.*, 286 U. S. 63; *Stuart* v. *Hayden*, 169 U. S. 1; *Dun* v. *Lumberman's Credit Association*, 209 U. S. 20.

It is submitted, therefore, that a covenant against re-entry is not unenforceable as contrary to Section 77 and to public policy; that where necessary there is ample power in the equity jurisdiction of the court to assure the continued operation of a railroad by the exercise of its injunctive power against the immediate exercise of the right of re-entry; that both the District Court and the Circuit Court of Appeals held that this was not a case in which the right of re-entry should be postponed; and that the concurrent findings of these two courts should be accepted as conclusive.

POINT III.

Certificates under Section 1 (18) of the Interstate Commerce Act are not necessary conditions precedent to operation of the railroad by the lessor.

The District Judge granted the motion to terminate the lease upon production to the court of conclusive evidence that the requirements of the laws relating to the continuous operation of the railroad had been complied with (R. 45). In order to satisfy this requirement, the lessor filed an application with the Interstate Commerce Commission to resume the operation of the railroad and in effect asked the Commission to find that the provisions of Section 1 (18) of the Act,* requiring a certificate of necessity and convenience before operation could be undertaken, did not apply, since the lessor was merely resuming operation of its own properties after temporary suspension during the existence of the lease. The petitioners herein sought and obtained leave to intervene in the proceedings before the Commission, and filed briefs. The Commission, in a formal report which indicates an exhaustive study of the question held that the lessor's application for a certificate was not within the purview of the statute, and that no certificate was required, since the lessor's obligations and duties to the public had never ceased, but have merely been performed by the lessee during the term of the lease (R. 56-57). The Commission therefore found that, independent of any certificate of necessity and convenience, the lessor had not only the right but the positive duty to resume the operation of the railroad, and in accordance with that finding, entered an appropriate order dismissing the lessor's application for a certificate (R. 57). Subsequently the District Court properly found that the requirements of the

* See Appendix, page 29.

laws relating to the continuous operation of the railroad had been complied with (R. 58).

Nor is there substance to petitioners' contention that the trustee must secure a certificate of abandonment from the Commission before he can turn over the railroad to the lessor. Abandonment connotes voluntary relinquishment. Here the trustee is not abandoning anything. The railroad is being taken by the lessor under its contractual rights with the lessee, against the will of the trustee and the lessee. Furthermore, the abandonment contemplated by the statute is an abandonment of railroad operation. There will be no cessation of operation in this case. It would be just as logical to argue that the debtor could not turn over the operation of the railroad to the trustee under the order of the court appointing a trustee herein without obtaining a certificate of abandonment, as it is to argue that the trustee cannot turn back the railroad to the lessor under the order of the court without securing such a certificate. The debtor of course made no such application. Let us assume that no petition for reorganization had been filed but that the Connecting Company was foreclosing a mortgage on the railroad. The rule for which petitioners contend would lead to the absurd conclusion that the mortgagor could defeat the foreclosure proceedings by refusing to apply for a certificate of abandonment. If the trustee feels that an application for a certificate of abandonment on his part is necessary to protect him from a violation of the Interstate Commerce Act he is perfectly free to make such an application now or at any time in the future. But his failure to do so can have no effect on the enforceability of the covenant against transfer in the lease.

It is not the petitioners' function to protect whatever public interest is involved in this matter. That is a matter solely between the Interstate Commerce Commission and the landlord. The Commission alone is charged with the

responsibility of enforcing the provisions of Section 1 (18). It could, in a proper case, under Sections 12 and 20 (9) of the act apply for a writ of mandamus to compel compliance with the provisions thereof. That however is a public function with which petitioners have no concern.

POINT IV.

Order No. 39 should not be reversed because it tranfers possession of certain railroad property, claimed by both the trustee and the lessor, to the lessor before determination of title thereto.

Petitioners Hoboken Manufacturers Railroad Company and Seatrain Lines, Inc. complain that Order No. 39 should be reversed because it provides that all property of the debtor in the possession or under the control of the trustee and presently held or used for railroad purposes shall be delivered to the lessor, notwithstanding conflicting claims thereto by the lessor and the trustee, and that claimants might thereafter file a claim with the Clerk of the Court for the recovery of such property or its value and reasonable compensation for its use, which claims will thereupon be determined by the Court, through reference to a Master or otherwise (R. 59).

This provision in the order was inserted at the suggestion of counsel for the trustee. It was an eminently practical suggestion, because the property in dispute, as is evident from the petitioners' brief, consists of two inconsequential lengths of track one about two hundred sixty-five feet in length, leading to a dead-end siding, and another about twenty feet long leading not to a float-bridge, as petitioners allege, but to a storage yard on land leased by debtor from the Delaware, Lackawanna and Western Railroad, which is of very little consequence in the operation of the railroad. The exclusion of either or both would

not impair the lessor's ability to operate the railroad in the slightest degree. Of course, they were worthless to the trustee standing by themselves. Consequently the trustee through his counsel suggested the provision in the order of which the other petitioners now complain. The effect of the provision is to permit the continued operation of these small tracts in conjunction with the railroad, while the question of whether or not they revert to the lessor upon the termination of the lease is being determined by a Master. If it should be determined that they do not revert, the trustee under the terms of the order will be entitled to proper compensation for their use. If it is determined that they do revert as the lessor claims, no harm has come of the order.

It is not disputed that practically all of the railroad property reverts to the lessor on termination of the lease. The amount in dispute is less than one-tenth of one per cent of the property involved, and has no vital bearing upon the operation of the railroad. Even if the court should find that the court below had no technical right to include such a provision in the order, no basis would be formed for the reversal of the order. At most the order should be reformed by rescinding the provision complained of.

Conclusion.

The judgment of the Circuit Court of Appeals for the Third Circuit should be affirmed.

Respectfully submitted,

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JOHN J. HICKEY,
of Counsel.

APPENDIX.

Interstate Commerce Act, U. S. C. A. Title 49, Sec. 1 (18), provides:

"(18) No carrier by railroad subject to this chapter shall undertake the extension of its line of railroad, or the construction of a new line of railroad, or shall acquire or operate any line of railroad, or extension thereof, or shall engage in transportation under this chapter over or by means of such additional or extended line of railroad, unless and until there shall first have been obtained from the Commission a certificate that the present or future public convenience and necessity require or will require the construction, or operation, or construction and operation, of such additional or extended line of railroad, and no carrier by railroad subject to this chapter shall abandon all or any portion of a line of railroad, or the operation thereof, unless and until there shall first have been obtained from the Commission a certificate that the present or future public convenience and necessity permit of such abandonment. Nothing in this paragraph or in section 5 shall be considered to prohibit the making of contracts between carriers by railroad subject to this chapter, without the approval of the Commission, for the joint ownership or joint use of spur, industrial, team, switching, or side tracks."